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Corporation--To be or not to be? Choice of entity issues for small businesses: A Speech for CPAs to deliver to general audiences

American Institute of Certified Public Accountants. Communications Division

CORPORATION--TO BE OR NOT TO BE?

CHOICE OF ENTITY ISSUES FOR SMALL BUSINESSES

A Speech for CPAs to Deliver to General Audiences

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Should I incorporate? This is usually the first question I hear when I'm meeting with a client who's starting a business.

Other types of questions I explore with my clients are: How does someone starting a new business decide what type of organization to adopt? When should an established business change its existing format? And, what are the tax and administrative ramifications of these decisions?

It's important to remember that no one entity is best for all situations. As new tax legislation is passed at an ever-increasing rate, choosing the appropriate form of business organization is becoming more complicated. Moreover, the choice of entity is not going to be a one-time decision. I always advise my clients to periodically review the issue.

Basically, there are three ways to organize your business: as a sole proprietorship; as a partnership, either general or limited; or as a corporation, either a C corp or an S corp. Another option is the limited liability company, or LLC, which is available in some states. LLCs are treated like partnerships for tax purposes, and like corporations for liability purposes.

(**OPTIONAL:** The points I will be making today are very technical, but don't worry about taking notes. I will hand out a brochure* that summarizes my talk.)

Although today we'll focus on the tax aspects of business organization, let's start by talking about the non-tax characteristics of these entities, including continuity and transferability; management and administrative tasks; and capitalization and liability.

A corporation is the only form of business with continuity of life. It does not cease to exist with the death of the owner, or with a change of ownership. Interest in a corporation is transferred simply by buying and selling shares of stock. Corporations are usually the best choice if continuity of life and the easy ability to bring in additional owners are major concerns.

*Note to speakers: We suggest that you distribute a brochure that highlights the points made in this speech. Copies can be ordered by calling 1-800-862-4272 or by faxing 1-800-362-5066, and requesting Product Number 889532.

Partnerships terminate altogether if 50% of the partnership interest is transferred within a twelve-month period. A deemed termination occurs whether the transfer is caused by a planned sale, by death or by bankruptcy. Interest in a partnership can be sold, but generally such sales are subject to the approval of the other partners.

In most states, LLCs must be dissolved if any member withdraws, unless the remaining members vote to continue the operation, or if there are other provisions to the contrary in the LLC operating agreement.

Proprietorships, on the other hand, cease at the death of the owner, or with the sale of the business.

Management and administrative burdens differ among the types of business entities as well. Specifically, this burden is lightest for a proprietorship and heaviest for a corporation. Partnerships and LLCs fall somewhere in-between.

Sole proprietorships are characterized by simplicity, flexibility and control. One person alone makes business decisions. Filing taxes is a simple process, too, since there is no need for a separate return. Sole proprietors report their business income on Schedule C of Form 1040, Federal Individual Income Tax Return.

Partnerships, LLCs and corporations are legal entities separate from their individual owners or shareholders, and they must file tax returns at the entity level.

In partnerships and LLCs, it's important to anticipate potential problems and spell out exactly how they are to be resolved. This is the purpose of the partnership or LLC operating agreement. I always insist on such an agreement for my clients, although there is no legal requirement for it. The agreement specifies not only how profit and loss are to be allocated, but also how operating issues are to be decided.

Corporations have strict legal requirements for incorporating and registering with the state. They must file articles with the secretary of state, issue annual registration reports and franchise tax returns. They also must hold annual meetings, elect a board of directors, and keep minutes of the board meetings. If a company does not adhere to these requirements, but operates as an extension of the owner or owners, it may lose some of the benefits of incorporation, including limited liability.

Access to capital also varies among entities. Proprietorships are usually limited to the assets available to the owner and to funds that can be borrowed based on the owner's personal credit worthiness.

Since there are more individuals capable of acquiring funds involved in partnerships, LLCs and corporations, these types of organizations have a larger potential source of capital.

For tax purposes, a corporation may elect to be treated as an S corporation. S corporations are limited to 35 shareholders, and must be individuals, estates, or certain types of trusts. They also are limited to one class of stock. S corporations can, of course, sell stock or bonds, and receive loans from financial institutions. Usually, shareholders of an S corporation must personally guarantee the debt of the corporation.

The most compelling non-tax argument for incorporation is the limited liability of the owners. The liability of corporate shareholders, limited partners and LLC owners is limited to their investment in the company, or to the assets of the corporation. On the other hand, proprietors and general partners have unlimited liability. However, if the potential risks associated with a business can be covered by insurance, this argument loses some of its strength.

Now let's focus on tax considerations, which often can be the deciding factor in choosing a form of operation.

Tax issues affecting the choice of entity decision involve pass-through entities; tax years; compensation and payroll taxes; passive activity rules; and the alternative minimum tax.

The most important tax-related decision you'll make is whether or not to operate as a pass-through entity. A pass-through entity itself is not subject to income tax; the owner or owners report items of income or loss on their individual tax returns. Sole proprietorships, partnerships, LLCs and S corporations are pass-through entities.

Even when they are profitable, pass-through entities benefit from a single level of taxation. Income from C corporations, on the other hand, can be subject to two levels of taxation. First, any income of the company is taxed at corporate rates. Then, retained earnings that are distributed as dividends, or liquidating distributions, are taxed again as shareholder income.

Which tax year to adopt might also help to determine your choice of entity. You'll want to avoid a year-end that falls during the busy time for your company. However, unless you are a C corporation, certain tax laws do limit your choice in this matter.

C corporations can choose the fiscal year that best suits their businesses, unless they are personal service corporations, or PSCs. PSCs are companies whose primary activity is providing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. PSCs, along with pass-through entities, must adopt a calendar year-end -- that is, December 31.

One exception to this general rule is known as a section 444 election. A section 444 election permits partnerships, S corporations and PSCs to choose a fiscal year ending September 30, October 31, or November 30, providing they adhere to certain requirements. And there is another exception to the calendar-year rule for pass-through entities and PSCs. If a business takes in 25% of its gross receipts in the last two months of the year, it can apply for what is called a business purpose fiscal year.

The treatment of compensation and payroll taxes also varies across entities, and it is one of the most important issues facing small businesses today. In considering compensation and payroll taxes, the first distinction we should make is between wage income and self-employment income.

Wage income is earned by employees who have a portion of Social Security and Medicare taxes withheld, along with federal, state, and local income taxes. The advantage of wage income is that FICA tax is owed only on the amount of business income that is actually paid as wages. Remember, though, that you must file payroll tax reports and pay taxes throughout the year, which can be burdensome.

Self-employment income is earned on all the net business income of a proprietor, general partner or LLC member, whether or not the cash is withdrawn from the business. If you are self-employed, you pay both the employer's and employee's share of Social Security and Medicare taxes. However, you are exempt from unemployment tax. Since you don't have tax withheld, you must calculate and pay personal estimated taxes on a quarterly basis.

If, as the owner of a company, you are the only compensated individual and withdraw most of the income, it's probably simpler to remain a proprietorship or partnership, and pay estimated taxes as an individual. If there are other employees, or if a significant amount of taxable income is to be retained in the company, it may be advisable to incorporate and pay yourself compensation in the form of wages.

Another important tax issue involves passive activity rules, a complicated part of the tax law that was put into place to restrict tax losses where there were no corresponding economic losses. A passive activity is a trade or business in which the taxpayer does not materially participate. Any rental activity is a passive activity by definition. These rules were introduced in 1986 to combat the proliferation of financially unsound tax shelter investments, but the actual effects are far-reaching, and can even limit the deductibility of your economic losses in some areas.

Not all entities are subject to these rules. If you expect your business to produce passive losses on an ongoing basis, it may make sense to operate as a C corporation. C corporations that are not closely held, or are not PSCs, are exempt from the passive activity rule. If you expect passive activities to produce income, consider choosing a pass-through entity, since this income can offset other passive losses your business might incur.

Alternative minimum tax (AMT) is another complex area of the tax law that affects only certain entities.

As you probably suspected, AMT is neither alternative nor minimum. Like the passive loss rules, AMT is an attempt to close tax loopholes for all entities. It involves items such as accelerated depreciation, excess intangible drilling costs, and some itemized deductions. For C corporations, tax-exempt earnings such as life insurance proceeds, tax-exempt interest and installment sale income are also included in the AMT calculation.

In addition, you should consider the built-in gains tax when choosing a business entity. The concept of a built-in gains tax dates from 1986. That year, new laws created the double taxation of corporate liquidations, and a flood of companies sought S status to obtain a single level of taxation. A built-in gains tax was put in place to prevent companies from electing S status and then selling their assets. This tax only affects C corporations who elect S status. Anyone planning to make this change should have an independent analysis done to calculate the projected built-in gains tax if any assets are sold within 10 years of the S election date. Intangibles and goodwill also should be valued in the event the entire company is sold.

Another type of built-in gains tax is the long-term capital gains tax, which is levied on large long-term capital gains recognized within three years following S election. LIFO recapture, which prevents C corporations from using the last-in, first-out (LIFO) inventory method to avoid built-in gains on inventory sales, is yet another type of built-in gains tax.

Both taxes affect the initial choice of S status when incorporating. However, the administrative burden and potential tax cost of switching from C status to S status can be enormous.

The final tax issue we need to consider concerns fringe benefits. These include retirement plans and life and health insurance.

Under previous tax law, the gap between fringe benefit allowances for corporations and pass-through entities was so great that many businesses incorporated just for these advantages. Although the gap is not so wide now, the corporate form of organization still provides a slight advantage in the area of retirement funding and an even greater edge when we talk about health insurance.

Corporate shareholders can have contributions to a retirement plan calculated on their wage income at the same rates as other employees. For a profit-sharing plan, the contribution can be up to 15% of each employee's salary, up to $150,000 of compensation. Proprietors and partners calculate their retirement contribution on self-employment earnings, but have to reduce those earnings by the amount of the deduction. This results in a maximum rate of 13.04%, instead of 15%. Employee contributions are still calculated at 15% of wages.

Generally, for C corporations, premiums for health insurance and group term life insurance are fully deductible, as long as the plans are nondiscriminatory -- meaning that highly compensated employees are not favored. There are limitations on the amount of benefits an employee can receive tax-free, so you may want to check with a CPA on this.

In general, S corporations can deduct both life and health insurance premiums for the owners as long as these amounts are included in the owners' income. Proprietors and partnerships, on the other hand, cannot deduct their owners' health or life insurance costs. However, proprietors, partners, and S corporation shareholders can include their health insurance costs as itemized deductions on their individual income tax returns. These are all complex issues and are subject to change, so it's important that you contact a CPA for more information.

Now that we've talked about both the tax and non-tax issues affecting your choice of business organization, hopefully you are a little closer to knowing which form of business entity to choose.

In closing, I would like to review a few key points. Most important, remember that no one type of entity is appropriate for all situations. My advice to clients is to start with the simplest form of organization that satisfies their needs. It's easiest to move along a continuum, starting with a sole proprietorship and moving into a partnership, LLC or S corporation, and finally to a C corporation.

I recommend that you develop a long-term relationship with a CPA. CPAs can help you navigate changing tax laws as you launch your business and set its course. Now, I'd be happy to take any questions you may have.

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